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OGC HAS REVIEWED.

23 December 1955

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MEMORANDUM FOR: Director of Personnel

ATTENTION:

SUBJECT: Grant of Allowances to Independent Contractors

1. For some time there has been consideration of various questions relating to the granting of allowances to contract agents and other independent contractor types. Involved are the various allowances including cost-of-living, quarters, education, and in some cases post differentials. Also involved has been the question of the propriety of exclusions of certain of these allowances for gross ~~exclusions~~ <sup>from</sup> <sup>income</sup> Federal income tax purposes.

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The President has prescribed appropriate regulations in Executive Order 10,100, dated 20 June 1949. In substance the Executive Order provides that the allowances granted by the Director of Central Intelligence shall conform to the allowances granted by the Secretary of State under the cited sections of the Foreign Service Act.

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3. For various purposes the Agency has established, by authority of the Director of Central Intelligence, categories of personnel. A contract agent is defined in [redacted] as a person engaged in operational duties who is not an employee. There are legal connotations to the determination that an individual is an independent contractor. There is ample legal precedent to serve as a guide in determining when an individual is an employee on the one hand and an independent contractor on the other. If it is determined that an individual is an employee, numerous Government-wide laws are applicable. For example, an employee would be eligible for benefits under the Federal Employees Compensation Act and the Annual and Sick Leave Act of 1951.

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4. The basic legal concept of an independent contractor is that under only a very general stipulation as to the nature in which he will perform his services he is paid a fee for those services. The fee is determined on the basis of negotiation considering uniqueness of his service, the need for his service, and many other factors. It is true that a person who has been engaged as a contract agent could, over a period of time, in fact become an employee. If this change in fact has occurred, it would be appropriate that the type of contract also be changed to reflect the new status. As a general rule, the current contract should be the controlling factor and unless controverted by the facts, the presumption would be against a change in status and the factual inconsistencies must be overwhelming.

5. Viewing the independent contractor in this general light it seems clear that in concept he cannot be the recipient of a grant of allowances which are authorized to be paid only to employees. It is true of course that his fee could be increased to cover those circumstances which normally are the occasion for such grants. However, the increase in his fee is just that. The additional compensation is merely measured by the guide lines established for cost-of-living or quarters allowances. It is not a true allowance and it is suggested that both contract terminology and regulatory terminology be changed to avoid the misconception that the additional amounts paid to independent contractors are in fact and nature similar to allowances granted to employees. Such amounts might well be called "overseas adjustments."

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6. There should now be considered the income tax aspects of this subject. Section 912(1) of the Internal Revenue Code of 1954 provides that the following items shall not be included in gross income and shall be exempt from taxation.

"(1) Cost-of-living Allowances.--In the case of civilian officers or employees of the Government of the United States stationed outside continental United States, amounts received as cost-of-living allowances in accordance with regulations approved by the President."

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a. Internal Revenue has considered the question of whether quarters allowances properly may be considered a cost-of-living allowance for purposes of tax exemption. In an unpublished opinion, Internal Revenue has ruled that the term "cost-of-living" is construed to include living quarters allowances. Thus, the following specific types of allowances granted to employees are exempt from Federal income taxation: (1) quarters allowances, (2) temporary lodging allowances, (3) cost-of-living allowances, (4) transfer allowances, (5) separation allowance, (6) representation allowances, and (7) education allowances. Neither foreign post differentials nor territorial post differentials are exempt from taxation. They are considered by Internal Revenue in the absence of any statutory exemptions as taxable in the same manner as other earned income.

b. Internal Revenue Service, in view of the use of the words officer and employee both in the cited statutory exemption and in the basic authorization, has indicated that the exemption can only be utilized by officers and employees. With respect to contract agents, therefore, and any other independent contractor types, payments of additional amounts which purport to be allowances of the type granted to employees are subject to Federal income taxation in the same manner as the basic compensation under the contract. It is possible, as indicated above, that certain persons who are presently included in the contract agent category or in some independent contractor type category are in fact employees and should be so considered. If it is so determined then, of course, they would be entitled to claim the exemption from taxation of any amounts received as cost-of-living allowances.

c. There should be considered in this connection the status of equalization allowances under existing regulations. From a tax standpoint as to independent contractor types there exists no basis in law for considering such allowances as exempt from Federal income taxation (equalization allowances are similar in nature to cost-of-living allowances). Consequently, as discussed above, it is inappropriate as a matter of concept to consider amounts paid to independent contractors in the same sense as equalization allowance paid to staff agents and other employee categories.

d. An additional question could be raised in the event the Agency determines that in lieu of what is now known as a quarters allowance an independent contractor type should be furnished, i.e. Government expense, appropriate living quarters. While section 119 of the Internal Revenue Code of 1954 provides for exclusion from gross income of the value of lodging furnished to an employee for the convenience of the employer again the exemption runs only in the case of an employee. Consequently, in an independent contractor situation the value of living quarters received would

be taxable to the same extent as the basic remuneration payable. It is possible that distinctions could be drawn in certain circumstances where the independent contractor is required by the Agency to live in far more ostentatious quarters than he would normally utilize in accordance with his particular station in life. However, such cases could only be decided by the particular circumstances involved.

7. It is realized that the application of the law as indicated above will cause some difficulties with respect to many individuals who were unaware of their income tax liabilities. However, the mandate of the law is clear and the Agency has a responsibility to the individuals concerned and particularly it has a responsibility to the Internal Revenue Service. Internal Revenue must rely on the Agency's statement of the amount of taxable income received by personnel associated with the Agency. Therefore, we must in good faith report where necessary in accordance with established procedures or advise the individuals the proper taxable compensation in each case. In view of possible complications, it is suggested that your office arrange with the other interested components of the Agency a program to carry out in orderly fashion any necessary changes. This Office will be pleased to assist in whatever way possible.

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Acting General Counsel

cc: Finance  
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C.R. Personnel 5